

NAIC/AICPA (E) Working Group  
Orlando, Florida  
March 8, 2006

The NAIC/AICPA (E) Working Group of the Financial Condition (E) Committee met in Orlando, FL on March 8, 2006. A quorum was present and Doug Stolte (VA) chaired the meeting. The following members were present: Ramon Calderon (CA); Darryl Reese (DE); Jim Armstrong (IA); Ken Skiera (IL); Judy Weaver (MI); Jaki Gardner (MN); David Krumm (NE); Thomas Burke (NH); Joe Fritsch (NY); Mike Motil (OH); Russell Latham (OR); Steve Johnson (PA); Danny Saenz (TX) and Steve Fry (UT).

1. Approve Minutes from Interim Conference Calls

Mr. Johnson moved and Mr. Latham seconded a motion to adopt the minutes from the conference calls held on Feb. 10, 2006 (Attachment XX), Feb. 16, 2006 (Attachment XX) and Feb. 22, 2006 (Attachment XX). The motion passed unanimously.

2. Receive Status Report on the Recent AICPA Activities

Liz Logan (PricewaterhouseCoopers) updated the Working Group on four of the projects currently being worked on by the American Institute of Certified Public Accountants: 1) Risk Assessment Standards – In March 2006, the Auditing Standards Board (ASB) will issue eight statements on auditing standards (SASs). The primary objective of the new SASs is to enhance auditors' application of the audit risk model in practice. The SASs will be effective for audits of financial statements for periods beginning on or after Dec. 15, 2006. An audit guide will be issued to assist practioners in implementing these standards; 2) AT 501 Revisions – On Jan. 19, 2006, the ASB issued an exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," (AT 501) of SSAE No. 10, *Attestation Standards: Revision and Recodification*. The exposure draft has been revised to incorporate definitions of various terms used in Public Company Accounting Oversight Board Auditing Standard No. 2; 3) ASB Readdresses Communication of Internal Control Matters – On Sept. 1, 2005, the ASB exposed a proposed SAS, *Communication of Internal Control Related Matters Noted in an Audit*, to enhance the auditor's ability to identify and communicate to management and those charged with governance, significant deficiencies and material weaknesses in internal control identified in a financial statement audit. At its January 2006 meeting, the ASB reviewed a draft of the proposed SAS that had been revised to reflect certain recommendations in comment letters and recommended additional revisions. At its April 2006 meeting, the ASB expects to vote on whether the document should be issued as a final SAS; and 4) Proposed SAS on Communication with Those Charged with Governance – At its January 2006 meeting, the ASB voted to ballot a draft of a proposed SAS, *The Auditor's Communication with Those Charged with Governance*, for issuance as an exposure draft. This proposed SAS establishes standards and provides guidance to an auditor on matters to be communicated with those charged with governance. The proposed SAS would replace SAS No. 61, *Communication with Audit Committees*, as amended.

3. Discussion and Adoption of the Collective Revisions to the Model Regulation Requiring Annual Audited Financial Reports

Mr. Stolte stated that at the 2005 Winter National Meeting, the Working Group voted to expose for a 45-day period the proposed revisions to the Model Regulation Requiring Annual Audited Financial Reports (Model Audit Rule). A total of 10 comment letters were received, and three conference calls were held in February 2006 to discuss the comments. Based on these calls, the Working Group agreed to make additional substantive and nonsubstantive refinements to the proposed revisions.

Julie Glaszczak (NAIC) summarized the proposed revisions to the Model Audit Rule. Regarding the topic of auditor independence, the adopted revisions reduce the number of consecutive years an audit partner may participate on the audit of an insurer and also lists various non-audit services that auditors may not provide to an insurer in order to maintain its independence. Realizing that it may be difficult for small insurers to comply with the prohibited services requirement, the Working Group incorporated a small company exemption that indicates that those insurance companies with less than \$100 million in direct written and assumed premium may request an exemption from this requirement.

Regarding the topic of corporate governance, the adopted revisions require that insurance companies have an audit committee that is responsible for the appointment, compensation and oversight of the company's auditor. The guidance also indicates that some audit committees, based on the insurer's premium volume, would need to be comprised of a certain percentage of individuals that are independent from company management. Companies meeting certain requirements may request an exemption from its domiciliary commissioner.

Regarding the topic of internal control over financial reporting, the adopted revisions require that insurance companies with \$500 million or more in direct and assumed premium file a report with the state insurance department regarding its assessment of internal control over financial reporting. This report will include a statement by management whether these controls are effective to provide reasonable assurance regarding the reliability of the statutory financial statements and disclosure of any unremediated material weaknesses in internal control over financial reporting. In addition, the proposed revisions require that the insurer file with the state insurance department the independent certified public accountant's communication regarding any unremediated material weaknesses noted during the course of an audit.

Bill Boyd (National Association of Mutual Insurance Companies-NAMIC) stated that although NAMIC has criticized some of the revisions related to auditor independence and corporate governance, it has not fundamentally objected to these revisions. He discussed that the Model Audit Rule revisions related to internal control over financial reporting are expensive, even though compromises made by the regulators are a step in the right direction. He discussed the belief that the costs to comply with the internal control requirements will still outweigh the benefits and that such requirements for mutual insurers are not warranted.

Steve Broadie (Property Casualty Insurance Association of America-PCI) stated that PCI believes that the revisions to the Model Audit Rule are a reasonable solution to the needs of both regulators and industry. He discussed that a key component to the revisions is the implementation guide and that the revisions should not moved forward in the adoption process without this guidance. He discussed that waiting to adopt the revisions until the implementation guide is complete should not be an issue since, for accreditation purposes, the revisions only need to be adopted by the full NAIC membership by the end of the year. Mr. Johnson indicated that waiting for the implementation guide would slow down the Working Group's progress. Some members of industry have voiced concern that the implementation guide may include requirements not included in the revisions to the Model Audit Rule. To quell this concern, the interested parties, rather than the regulators, are creating the first draft of the guide. Mr. Johnson noted that NAIC leadership has expressed that the Model Audit Rule revisions should continue to progress through the committee process.

Ed Stephenson (Barnert & Associates, Inc.) stated that the Working Group is aware of his objection to requirements in the proposed revisions related to independent audit committee members. He indicated that this objection would continue as the proposed revisions progress through the committee process. Mr. Johnson stated that he still does not understand why privately held companies would not want to have outside expertise on its audit committees. The appointment of outside counsel with an independent view of the company is beneficial regardless of the organizational structure. He discussed that the Model Audit Rule does not mandate the composition of the board of directors, but rather the audit committee. Mr. Stephenson replied that the revisions to the Model Audit Rule require the appointment of independent directors in order to serve as independent audit committee members.

Phil Carson (American Insurance Association-AIA) discussed his appreciation that the regulators worked with members of industry on drafting the proposed revisions. He indicated that AIA is supportive of the revisions and any previous concerns have been resolved. He agreed that the implementation guide would be an important piece to ensuring compliance with the new requirements.

Mr. Johnson discussed that 17 years ago, the NAIC began creating the building blocks to improve financial solvency regulation by developing the accreditation program, RBC requirements and codification of accounting principles. He noted that the proposed revisions to the Model Audit Rule related to auditor independence, corporate governance and internal control over financial reporting are the final building block. Mr. Johnson moved to adopt the proposed revisions to the Model Audit Rule (Attachment XX) with three stipulations: 1) editorial changes to Section 17; 2) a recommendation that the Annual Statement Instructions for Annual Audited Financial Reports should not be changed for any of the proposed revisions, and that states be encouraged to adopt the revisions through specific legislative or regulatory action; and 3) a recommendation that the Financial Condition (E) Committee expose this entire proposal for 45 days and then hold a public hearing to address any additional comments. Mr. Motil seconded the motion. A roll call vote was taken, and the motion passed with Utah as the only member voting against the motion.

#### 4. Discussion of Next Steps

Alan Close (Alan E. Close Consulting, LLC) discussed the interested parties' progress on the drafting of the implementation guide, noting that a draft of the guide will be available for distribution within the next few weeks. Mr. Stolte stated that other "next steps" such as accreditation considerations and a process for maintaining the Model Audit Rule will be discussed at the Summer National Meeting.

#### 5. Update from NCOIL Meeting Held on Feb. 24, 2006

Mr. Stolte discussed that Ms. Weaver attended the Feb. 24, 2006 National Council of Insurance Legislators (NCOIL) meeting. He noted that the Working Group has been very attentive in addressing the concerns of NCOIL since receiving a letter from them on March 10, 2005. Representatives of the Working Group have attended NCOIL meetings to discuss the progress of the revisions related to the Model Audit Rule and to answer questions. During a meeting in July 2005, Mr. Stolte promised NCOIL that the Working Group would work with members of industry and the trade associations to develop an acceptable work product. He believes that this has been accomplished. Mr. Stolte noted that NCOIL adopted a resolution at its Feb. 24, 2006, which questioned the value of the revisions to the Model Audit Rule.

Paul Donohue (NCOIL) discussed that in addition to Ms. Weaver, Mr. Close and representatives from PCI, the American Council of Life Insurers and NAMIC attended the NCOIL meeting, during which the NCOIL membership unanimously voted to adopt the resolution. He also noted that further communication between the legislators and the regulators would be welcome.

Ms. Weaver stated that at the NCOIL meeting, she explained that the revisions to the Model Audit Rule represent a missing tool from the current regulatory regime. The resolution that was passed appeared to be already set in stone even before the meeting took place. She was surprised by the resolution as the regulators have compromised with the members of industry as NCOIL had requested. In addition, she noted that the resolution includes some inaccuracies. Mr. Stolte stated that the proposed requirements to the Model Audit Rule will play an important role in the NAIC's modernization efforts related to principles-based valuation, the work of the International Association of Insurance Supervisors and the new risk-focused surveillance framework.

Neil Alldredge (NAMIC) discussed that the resolution was not passed because the NCOIL members did not understand the revisions to the Model Audit Rule, but rather because they disagreed with the revisions. He does not believe that the current revisions to the Model Audit Rule represent a compromise by the regulators. He stated that NCOIL members do not see any problems that the resolution fixes and that the costs to comply with the requirements continue to outweigh the benefits. Mr. Stolte noted that at the July 2005 meeting, Representative Joe Hune (MI) asked the regulators and NAMIC to work together to find a compromise. Mr. Stolte stated that NAMIC has refused to come to the table to work with the regulators. Mr. Alldredge responded that this was accurate and that this has been intentional. He said that at the meeting, NAMIC agreed to work with the regulators if they were to look at the current solvency framework in an attempt to fix it. However, he stated that NAMIC would not engage in a process to apply elements of Sarbanes-Oxley to non-public companies.

Mr. Johnson noted that NCOIL represents only a portion of state legislators. He also stated that he has never indicated that there is a problem with current financial regulation, but rather there is a missing piece. That missing piece is that the regulators do not currently receive positive assurance about a company's internal control. In addition, consideration of internal control over financial reporting and the other elements of the proposed revisions are simply good business practices. Mr. Stolte reiterated that the proposed revisions do not simply mirror Sarbanes-Oxley, and that the final proposed requirements related to internal control are quite different from Sarbanes-Oxley. He noted that, among other things, a company can use existing internal control documentation. Mr. Alldredge agreed that the revisions do not simply mirror Sarbanes-Oxley but rather represent elements of Sarbanes-Oxley. Mr. Stolte indicated that the regulators would be happy to meet with the members of NCOIL or any other state legislators to discuss the revisions to the Model Audit Rule.

Having no further business, the NAIC/AICPA (E) Working Group adjourned.

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